Internal Revenue Service

memorandum

CC:TL-N-6498-91
Br2:LSMannix

date: JUL 31 1991

to: District Counsel, Chicago MD:CHI
Attn: James M. Cascino

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted] and [redacted], and Alaskan Native Corporation

This is an interim response to your request for Tax Litigation advice, dated April 29, 1991. It is our understanding that [redacted]'s [redacted] taxable year is currently under examination and the extension of the statute of limitations expires on [redacted]. It is also our understanding that the [redacted] taxable year of [redacted] is closed.

As of the date of this response, we have not received certain critical documents--specifically the Form 870 AD executed by [redacted] and the Appeals Division and the Appeals Supporting Statement with respect to the Form 870 AD--that will most likely impact on the issue stated below. (The necessary documents have been requested by District Counsel, Anchorage, from the Fresno Service Center.) We are also coordinating the issue of whether the Service can or should, in effect, violate the integrity of the Form 870 AD in this case with the Appeals Division. Therefore, we cannot give you our final response to your request for advice at this time. Once we have received the necessary documents and have completed our coordination, we will send you our final response. We expect that we will send you our final response prior to September 15, 1991.

ISSUE

Whether income assigned from [redacted] to [redacted], under section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), in excess of [redacted]'s losses and credits, "springs back" to [redacted] notwithstanding that the Commissioner previously left the excess income with [redacted], [redacted] and the Appeals Division executed a Form 870 AD and [redacted] paid the resulting deficiency.

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CONCLUSION AND RECOMMENDATION

Generally, the Chief Counsel's position is that any income assigned by a profitable corporation, like [redacted], to an Alaskan Native Corporation ("ANC"), like [redacted], under section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), in excess of the ANC's losses and credits as finally determined by the Service "springs back" to the profitable corporation. However, the execution of the Form 870 AD in this case may prevent the "spring back." We are currently awaiting the necessary documentation in order to verify the contents of the Form 870 AD and whether any other evidence impacts on the agreement between the parties. We are also coordinating the issue of whether the Service can or should, in effect, violate the integrity of the Form 870 AD with the Appeals Division. Therefore, we cannot give you our final response as to whether the excess income in this case "springs back" to [redacted] until we have verified the contents of the Form 870 AD and other documents and determined the Service's position with respect to whether we can or should violate the Form 870 AD in this case.

FACTS

According to the materials you sent us, the additional materials FAX'ed to us from District Counsel, Anchorage, on July 15, 1991, and discussions with District Counsel, Anchorage, the facts, as we understand them at this time, are as follows. In this respect, please note that we qualify this advice on the grounds that we have been unable to obtain a copy of the Form 870 AD discussed below and there has been a great deal of confusion over its contents. At this time, we are relying on our knowledge generally of what a Form 870 AD usually states and what field personnel have told us the specific Form 870 AD in this case stated. If these assumptions prove to be in error, we advice you to notify us immediately so that we may amend our response.

During both [redacted]'s and [redacted]'s [redacted] taxable years, [redacted] assigned income to a subsidiary of [redacted] under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) in amounts equal to the amount of the losses and credits originally claimed by [redacted] in that year. [redacted] assigned the income to [redacted] through the means of a jointly controlled subsidiary called [redacted] ("[redacted]") and service contracts between [redacted] and [redacted] subsidiaries.

On [redacted], [redacted] entered into an agreement with [redacted] in which [redacted] transferred to [redacted] all the Class A common stock in [redacted] in exchange for $[redacted]. [redacted] retained ownership of all the outstanding

preferred stock and all the outstanding Class B common stock of [redacted] which it had received upon the formation of [redacted] in exchange for a total of $[redacted]. According to the taxpayers, [redacted] obtained in excess of [redacted]% voting control over [redacted] due to its ownership of the Class A common stock. Pursuant to the same agreement, [redacted] gave [redacted] an option to purchase all of its shares of [redacted] Class A common stock any time prior to, or on, [redacted], for $[redacted]. [redacted] exercised this option and purchased the Class A common stock from [redacted] on [redacted].

[redacted] also entered into an agreement with [redacted] in which [redacted] would provide services to [redacted] in exchange for $[redacted]. Because [redacted] did not have the personnel to perform the services, it contracted with subsidiaries of [redacted] to perform the services in exchange for $[redacted].

[redacted] was included in [redacted]'s affiliated group for its taxable year ended [redacted], and the assigned income (the service income less expenses) was included in [redacted]'s consolidated return for the same year.

After the above described transactions were executed, [redacted] and [redacted] received a letter ruling from the Chief Counsel's Office stating that it would not challenge the assignment of income from [redacted] to [redacted] and that any income assigned by [redacted] to [redacted] in excess of [redacted]'s losses and credits would "spring back" to [redacted] and be reported on its income tax return.

The Appeals Division settled the audit of [redacted]'s [redacted] through [redacted] taxable years through the means of a Form 906 and a Form 870 AD in [redacted]. In the Form 906, [redacted] and the Commissioner agreed to the tax basis of certain property with respect to which [redacted] was claiming losses. The agreement as to the tax basis of certain property in the Form 906 reduced the amount of [redacted]'s losses as originally claimed by [redacted] and, thus, [redacted] assigned an amount of income to [redacted] in excess of the losses so redetermined. The Form 870 AD states [redacted]'s tax deficiency for its [redacted] taxable year that results from agreement of the tax basis of certain properties, contained in the Form 906, which reduced the amount of the losses as originally claimed by [redacted]. Furthermore, included in Appeal's computation of [redacted]'s [redacted] tax deficiency is a loss carryback from [redacted]. The deficiency stated in the Form 870 AD is $[redacted]. The amount was later assessed against [redacted] by the Commissioner and paid on [redacted]'s behalf by [redacted].

Implicit in the Appeals settlement of [redacted]'s [redacted] taxable year is that the full amount of the income assigned by [redacted] to [redacted], as described above, was left in [redacted]'s

gross income. According to Appeals, the issue of whether income assigned by [redacted] to [redacted] in excess of the amount of [redacted]'s losses as finally determined in the Appeals settlement and as recomputed based on the tax basis of certain property agreed to by [redacted] and the Commissioner in the Form 906 was not considered.

[redacted]'s [redacted] taxable year is currently under audit by the Commissioner. [redacted] has excluded the entire amount of income assigned to [redacted] pursuant to the above described transactions from its gross income without any adjustment for the redetermined losses of [redacted]. Your request for advice states that if the excess income is left with [redacted]:

> ...revenue loss will result from the first $[redacted] of income being taxed at lower rates to [redacted] than [redacted] and, more importantly, from [redacted]'s ability to carryback the [redacted] net operating loss of $[redacted] to [redacted] that than forward to [redacted] and/or subsequent years. Since it is not known when, if ever, [redacted] would be able to utilize the [redacted] net operating loss (in the absence of a carryback against the overassigned income from [redacted]), the exact revenue loss is not known at this time. However, the Government will at least lose the tax rate difference on the first $[redacted] of overassigned income, the tax rate difference between the [redacted] and [redacted] rates on the net operating loss and two years of interest on the taxes saved from the carryback of the net operating loss.

DISCUSSION

Prior to 1985, I.R.C. § 1504(a) stated that a corporation was part of an affiliated group that qualified to file consolidated returns if 80% of its voting stock and 80% of each class of its nonvoting stock was held by the common parent of the group or another member of the group the owner of whose stock met the same test. The term "stock" for this purpose did not include nonvoting stock that was limited and preferred as to dividends. As part of the Tax Reform Act of 1984, Congress amended section 1504(a) by stating that the 80% ownership requirement meant ownership of 80% of the voting stock and 80% in value of both the voting and nonvoting stock of the corporation. Tax Reform Act of 1984, Pub. L. No. 98-369, § 60, 98 Stat. 494, 577-579. Congress also stated that for this purpose, the term "stock" does not include stock that is nonvoting, nonconvertible, and limited and preferred as to both dividends and in liquidation.

As part of the Tax Reform Act, Congress also exempted certain corporations and transactions from the new section 1504(a) affiliation rules. One such group was Alaskan Native Corporations ("ANC's"). Section 60(b)(5) of the Act stated:

> The amendments made by subsection (a) shall not apply to any Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.) during any taxable year beginning before 1992 or any part thereof in which such Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1)).

Although the legislative history to the statute is silent, the purpose of section 60(b)(5) was to allow ANC's to sell their losses to profitable corporations, in a manner similar to the transactions here at issue, thereby benefiting the financially troubled ANC's. The financial incentive to the profitable corporations for entering into the transactions was that their tax liabilities were reduced. However, section 60(b)(5) was not considered sufficient for this purpose and, as part of the Tax Reform Act of 1986, Congress replaced the statute with the following provision:

> (A) In the case of a Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.), or a corporation all of whose stock is owned directly by such corporation, during any taxable year (beginning after the effective date of these amendments and before 1992), or any part thereof, in which the Native Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1))--
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> > (i) the amendment made by subsection (a) [of section 60 of the Tax Reform Act of 1984] shall not apply, and
> >
> > (ii) the requirements for affiliation under section 1504(a) of the Internal Revenue Code of 1986 before the amendment made by subsection (a) shall be applied solely according to the provisions expressly contained therein, without regard to escrow arrangements, redemption rights, or similar provisions.
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> (B) Except as provided in subparagraph (C), during the period described in subparagraph (A), no provision of the Internal Revenue Code of 1986 (including sections 269 and 482) or principle of law shall apply to deny the benefit or use of losses incurred or credits earned by a corporation described in subparagraph (A) to the affiliated group of which the Native Corporation is the common parent.
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> (C) Losses incurred or credits earned by a corporation described in subparagraph (A) shall be subject to the general consolidated return regulations, including the

ovision relating to separate return limitation years, and section 382 and 383 of the Internal Revenue Code of 1986.

(D) Losses incurred and credits earned by a corporation which is affiliated with a corporation described in subparagraph (A) shall be treated as having been incurred or earned in a separate return limitation year, unless the corporation incurring the losses or earning the credits satisfies the affiliation requirements of section 1504(a) without application of subparagraph (A).

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(e)(4), 100 Stat. 2085, 2801. The 1986 amendments are effective as if included in the 1984 Act. Pub. L. No. 99-514, § 1881, 100 Stat. 2914.

The Conference Committee Report to the 1986 amendments states:

The conference agreement also provides that, during the applicable transition period, the affiliation requirements of the consolidated returns provisions will be applied to Alaskan Native Corporations (and their wholly owned subsidiaries),..., solely by reference to the express language in those provisions. Thus, eligibility for affiliation in the case of such corporations will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting tests, without regard (for example) to the value of the stock owned, to escrow arrangements, voting trusts, redemption or conversion rights, stock warrants or options, convertible debt, liens, or similar arrangements, or to the motive for acquisition of the stock or affiliation.

In addition, with certain specified exceptions, no provision of the Internal Revenue Code or principle of law will be applied to deny the benefit of losses or credits of Native Corporations (or their wholly owned subsidiaries) to the affiliated group of which the corporation is a member or of the specified group of corporations, during the applicable transition period. Thus, in general, the benefit of such losses and credits may not be denied in whole or in part by application of section 269, section 482, the assignment of income doctrine, or any other provision of the Internal Revenue Code or principle of law.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-1, II-843, 1986-3 vol. 4 C.B. 1, 843.[1]

No less than 39 ANC's that were assigned income from one or more profitable corporations under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) have been audited or are presently under audit by the Service. Although other variations exist, some of the transactions were much like the transaction involving [redacted] and [redacted] at issue here. Approximately 26 letter rulings were issued to taxpayers who engaged in transactions under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986). Of these, approximately 22 contain generally the same "spring back" language that is contained in the letter ruling to [redacted] and [redacted].

A substantial portion of the losses claimed by the ANC's, which were used to offset the assigned income, were with respect to timber property. A substantial portion of these claimed losses were or are being disallowed by the Service. Thus, the instant issue--Whether the excess income "springs back" to the profitable corporation--is present in virtually all such cases.

The "spring back" rule was developed in the context of certain transactions executed under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), like the transaction involving [redacted] and [redacted], in which the profitable corporation's tax rate for the year from which the income was assigned was higher than the ANC's tax rate for the year to which the income was assigned--because the profitable corporation's tax year was pre-Tax Reform Act of 1986 and the ANC's year was post-Tax Reform Act of 1986. In such cases, "tax rate arbitrage" could occur, wherein profitable corporations would attempt to assign excess income to ANC's in order to have the income taxed at a lower rate. Technical determined that the profitable corporation could only assign income up to the amount of the ANC's losses and credits. Any excess income that was assigned to the ANC's would "spring back" to the profitable corporation and be included in its return and taxed at its tax rate.

The specific rule of law upon which the "spring back" rule rests is that section 60(b)(5) of the Tax Reform Act of 1984 (as

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[1] The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5021, 102 Stat. 3342, 3666-3668, repealed section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) generally for losses or credits which arise after April 26, 1988.

amended by section 1804(e)(4) of the Tax Reform Act of 1986) only applied to income assigned by a profitable corporation up to the amount of an ANC's losses and credits and, likewise, the prohibition in section 1804(e)(4) against the use of sections 269 and 482, assignment of income principles or any other principle of law only applied up to the amount of the ANC's losses and credits. Any amount of assigned income in excess of the ANC's losses and credits would be included in the profitable corporation's income pursuant to the normal application of sections 269 and 482, assignment of income principles or other relevant principles of law.

In the transaction at issue and the other ones we have examined, we believe that the excess income is taxable to the profitable corporation. These transactions included situations in which the profitable corporation transferred unaccrued rights to income to a subsidiary controlled jointly by the profitable corporation and the ANC; the profitable corporation transferred income producing assets to such a subsidiary or a partnership while retaining an option to repurchase the ANC's stock in the subsidiary; the profitable corporation transferred an asset to such a subsidiary and then purchased an option to purchase the asset at a grossly inflated price; or, as in this case, the profitable corporation entered into sham service contracts to assign income to the ANC. No income assigned by a profitable corporation in excess of the ANC's losses and credits should remain with the ANC in such cases.

In cases where there was merely an assignment of receivables or other assignment that clearly would be impermissible under assignment of income principles, we think that the technically correct answer is that the excess income should "spring back." Furthermore, the Service should treat ANC's that received such assignments but that cannot rely on letter rulings consistently with ANC's that received such assignments and can rely on letter rulings. In this context, it should also be noted that Technical has informed us that the technically correct answer is that the excess income should "spring back" and that it is unwilling to alter any of its letter rulings in order to amend or delete the "spring back" language.

In the cases where there was a transfer of income producing property or stock of a corporation that contained income producing property the assignment of income doctrine arguably does not apply. However, strong arguments can be made that other principles of law would apply to require any excess income to "spring back." In virtually all of these transactions, because the profitable corporations retained so much control over the stock transferred to the ANC's and the ANC's only owned the stock for a short period of time, it can be argued that the transfer was a sham and, therefore, section 60(b)(5) of the Tax Reform Act

of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) does not apply; i.e., in so far as there was income in excess of the ANC's losses assigned to the ANC's. See Gregory v. Helvering, 293 U.S. 465 (1934). It could also be argued that the affiliation rules of section 1504(a) are not met in such cases, and that, therefore, section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) does not apply, because the ANC's did not have real voting control because of restrictions placed on the stock by the profitable corporations. See Lerner, Antes, Rosen & Finkelstein, Federal Income Taxation of Corporations Filing Consolidated Returns, § 2.03[3], and citations therein.

Both arguments can be made with respect to the transaction involving [redacted] and [redacted]. First, the service contracts between [redacted], its subsidiaries and [redacted] were clearly sham transactions with no economic substance and were entered into for no other reason than to assign income to [redacted]. Second, [redacted]'s affiliation with [redacted] for consolidated return purposes can be challenged because at the time [redacted] received stock in the jointly held subsidiary, [redacted] gave [redacted] an option to purchase [redacted]'s [redacted] stock at a set price and [redacted], in fact, purchased the stock from [redacted] a short time after the stock was transferred to [redacted]. Furthermore, various restrictions existed with respect to the Class A common stock owned by [redacted] that prevented [redacted] from having substantive control over [redacted] and the Class B common stock owned by [redacted] was convertible into Class A common at any time which, upon conversion, would give [redacted]% control over [redacted].

Furthermore, with respect to the transactions we have examined, we think it unreasonable to make a distinction between ANC's that structured their transactions with profitable corporations in such a way as to require a substance over form or sham transaction argument to recast the transaction and ANC's that entered into transactions that were clearly assignments of unaccrued income. The benefits and burdens of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) should be applied consistently in these cases without reference to the form of the transactions.

We acknowledge that some exposure exists with respect to the position that the excess income "springs back" to the profitable corporation. However, legal principles, the Department of Justice's reluctance to defend cases in which the excess income is left with the ANC and Technical's refusal to amend its position or letter rulings leaves us little alternative but to take the position that the excess income "springs back," at least with respect to the transactions we have examined.

The effect of this conclusion is that any income assigned by [redacted] to [redacted] in excess of [redacted]'s losses and credits as finally determined by the Service--such excess resulting from a recomputation of [redacted]'s losses based on the agreement between [redacted] and the Commissioner as to the tax basis of certain properties, contained in the Form 906--"springs back" to [redacted]. Therefore, this excess income should be included in the gross income of the [redacted] on its consolidated return.

However, the execution of the Form 870 AD in this case may prevent the "spring back." An argument could be made that putting the excess income in [redacted]'s gross income, in effect, violates the Form 870 AD executed by [redacted] and the Appeals Division. The rationale for such an argument is that if it is determined that the excess income "springs back" to [redacted], the same income would be taxed twice--once in [redacted]'s gross income and once in [redacted]'s gross income--and because two taxpayers cannot be taxed on the same income, [redacted] would be entitled to a refund. However, giving [redacted] a refund may violate the Form 870 AD.

We are currently awaiting the necessary documentation in order to verify the contents of the Form 870 AD and determine whether any other evidence impacts on the agreement between the parties. We are also coordinating the issue of whether the Service can or should, in effect, violate the integrity of the Form 870 AD with the Appeals Division. Therefore, we cannot give you our final response as to whether the excess income in this case "springs back" to [redacted] until we have verified the contents of the Form 870 AD and other documents and determined the Service's position with respect to whether we can or should violate the Form 870 AD in this case.

If you have any questions, please contact Lawrence S. Mannix at FTS 566-3470.

MARLENE GROSS

By: _____
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